DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 05-0500
Indiana Financial Institutions Tax
For Years 2000-2001

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ISSUE

I. **Financial Institutions Tax**- Combined Return

Authority: IC § 6-8.1-5-1(b); IC § 6-5.5-2-1(a); IC § 6-5.5-2-4; IC § 6-5.5-4-2; IC § 6-5.5-5-1(a); IC § 6-5.5-1-17(d)(2); IC § 6-5.5-1-18; 45 IAC § 17-3-5(d); 45 IAC § 17-3-10; *Allied Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992); *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977), *reh'g denied*, 430 U.S. 976 (1977); *State v. Sproles*, 672 N.E.2d 1353, 1360 (Ind. 1996).

Taxpayer protests the Department's adjustments to its combined return.

II. **Tax Administration**- Penalty

Authority: IC § 6-8.1-10-2.1; 45 IAC § 15-11-2; *Indiana Dept. of State Revenue v. Harrison Steel Castings Co.*, 402 N.E.2d 1276, 1278 (Ind. Ct. App. 1980).

The taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is the parent corporation of a group of affiliate corporations. The taxpayer filed combined financial institutions tax returns for tax years 2000 and 2001. On audit, the Indiana Department of Revenue ("Department") adjusted the taxpayer's combined returns to include two corporations and the income of the two corporations. The Department issued proposed assessments to the taxpayer reflecting the adjustments. The taxpayer submitted a protest challenging the assessment. The Department held a hearing and now presents this Letter of Findings, with additional facts to follow.

I. **Financial Institutions Tax**- Combined Return

DISCUSSION

The taxpayer disputes the audit's adjustments to its combined return, in which two corporations and the two corporation's income were included on the return. According to the taxpayer's protest brief, its directly owned subsidiary ("Bank") - an Indiana financial institution - holds a hundred percent of the shares of a non-resident investment management corporation ("Corporation A"). Corporation A in turn holds a hundred percent of the shares of another non-resident investment management corporation ("Corporation B"). Collectively, Corporation A and Corporation B own a non-resident limited partnership ("Partnership). Corporation A has a one percent interest in the Partnership and serves as the general partner. Corporation B has a ninety-nine percent interest in the Partnership and serves as the limited partner. The Partnership generates income by holding and managing a portfolio of investment securities. The taxpayer contends the adjustments made to the combined return were inappropriate for the following reasons: (1) both Corporation A and Corporation B are excludable from the combined return; (2) the income of Corporation A and Corporation B was not subject to tax; (3) Corporation B was not a subsidiary of a financial institution; and (4) the Commerce Clause precludes Indiana from taxing the income of Corporation A and Corporation B.

Indiana Department of Revenue assessments are prima facie evidence that the department's claim for unpaid taxes is valid. IC § 6-8.1-5-1(b). The taxpayer has the burden of proving whether the department incorrectly imposed the assessment. Id. The Department will separately address the taxpayer's contentions.

A. Excluding Corporation A and Corporation B from the Combined Return

The audit review determined since taxpayer owned a hundred percent of the voting stock of the corporations, the taxpayer could not exclude the entities from its combined return. Nevertheless, the taxpayer claims neither Corporation A nor Corporation B received a benefit or contributed to the taxpayer or its affiliates in transacting the business of a financial institution. Thus, Corporation A and Corporation B do not represent a part of the taxpayer's unitary business; and accordingly, the corporations are not includable on the taxpayer's combined return.

IC § 6-5.5-5-1(a) states "a unitary group consisting of at least two (2) taxpayers shall file a combined return covering all the operations of the unitary business and include all of the members of the unitary business." A unitary group for purposes of the financial institution tax is composed of those taxpayer members that are engaged in a unitary business. 45 IAC § 17-3-5(d). If one member of a unitary group is conducting the business of a financial institution in Indiana, then all members of the unitary group engaged in a unitary business must file a combined return, even if some of the members are not transacting business in Indiana. Id. Under IC § 6-5.5-1-18 (amended 2002),

> (a) "Unitary business" means business activities or operations that are mutual benefit, dependent upon, or contributory to one another, individually or as a group, in transacting the business of a financial institution. The term may be applied within a single legal entity or between multiple entities and without regard to whether each entity is a corporation, a partnership, a limited liability company, or a trust, provided that each member is either a holding company, a regulated financial corporation, a subsidiary of

> either, a corporation that conducts the business of a financial institution under IC § 6-5.5-1-17(d)(2), or any other entity, regardless of its form, that conducts activities that would constitute the business of a financial institution under IC § 6-5.5-1-17(d)(2) if the activities were conducted by a corporation. The term "unitary group" includes those entities that are engaged in a unitary business transacted wholly or partially within Indiana.
> (b) Unity is presumed whenever there is unity of ownership, operation, and use evidenced by centralized management or executive force, centralized purchasing, advertising, accounting, or other controlled interaction among entities that are members of the unitary group, as described in subsection (a). However, the absence of these centralized activities does not necessarily evidence a nonunitary business.
> (c) Unity of ownership, when a corporation is involved, does not exist unless that corporation is a member of a group of two (2) or more business entities and more than fifty percent (50%) of the voting stock of each member of the group is directly or indirectly owned by:
>
> (1) a common owner or common owners, either corporate or noncorporate; or
> (2) one (1) or more of the member corporations of the group.

Interpreting IC §6-5.5-1-18 – ***before the 2002 amending added "[h]owever, the term does not include an entity that does not transact business in Indiana" and as applicable to the tax years at issue*** — the inclusion of a corporation on a combined return is contingent on whether the corporation represents a part of the taxpayer's unitary group. A corporation forms a part of a unitary group by "engaging in a unitary business". A corporation has indicia of "engaging in a unitary business" when: (1) each member is a holding company, a regulated financial corporation, a subsidiary of either, or a corporation that satisfies IC § 6-5.5-1-17(d)(2); and (2) the corporation establishes a presumption of unity. Once these indicia are established, only one member of the unitary group needs to engage in the business of a financial institution for the Department to include all the unitary group members on a combined return.

Upon reviewing the taxpayer's Form 10-K, on file with the Securities and Exchange Commission, a discrepancy exists concerning the organizational structure the taxpayer proffers in its protest brief. For the periods at issue, taxpayer's Form 10-K specifically states as follows,

> ***Bank also has two investment subsidiaries, [Corporation A] and [Corporation B], which were established to hold and manage certain securities as part of a strategy to manage taxable income and reduce taxable expense. [Corporation A] and [Corporation B] subsequently entered into a limited partnership agreement, [Partnership].*** (emphasis added)

Thus, the Department takes the viewpoint that since the taxpayer in its Form 10-K considers the corporations subsidiaries of an Indiana financial institution that contribute to the taxpayer and/or its affiliates in reducing exposure to taxation, then the corporations are a subsidiary of a financial institution. Moreover, after inquiring with the Secretary of State office where both Corporation A and Corporation B are commercially domiciled, the office indicated both Corporation A and Corporation B had common management with Bank through shared directors and officers.

Hence, in the absence of definitive evidence to rebut or clarify the discrepancy, the audit was correct to conclude Corporation A and Corporation B satisfied IC § 6-5.5-1-18 and formed a part of the taxpayer's unitary group. Accordingly, the taxpayer did not overcome its burden that the audit improperly included Corporation A and Corporation B on its combined return.

B. Taxability of Corporation A and Corporation B Income on the Combined Return:

The audit review adjusted the taxpayer's combined return to include the income of Corporation A and Corporation B. The taxpayer claims the audit is indirectly attempting to tax Partnership by attributing Partnership's income to Corporation A and Corporation B in their capacity as partners on the combined return. The taxpayer asserts the audit has no basis for including the Partnership's income on the combined return since Partnership was not a financial institution and did not transact the business of a financial institution.

Under IC § 6-5.5-2-1(a), "there is imposed on each taxpayer a franchise tax measured by the taxpayer's adjusted gross income or apportioned income for the privilege of exercising its franchise or the corporate privilege of transacting the business of a financial institution in Indiana." Per IC § 6-5.5-2-4,

> For a taxpayer filing a combined return for its unitary group, the group's apportioned income for a taxable year consists of:
> (1) the aggregate adjusted gross income, from whatever source derived, of the members of the unitary group; multiplied by
> (2) the quotient of:
> (A) all the receipts of the taxpayer members of the unitary group that are attributable to transacting business in Indiana; divided by
> (B) the receipts of all the members of the unitary group from transacting business in all taxing jurisdictions

Since Corporation A and Corporation B represent a part of the taxpayer's unitary group, receipts of the corporations are includable in the taxpayer's apportionment factor. The attribution rules of IC § 6-5.5-4 determine the receipts that are included in the apportionment factor. Per IC § 6-5.5-4-2,

> For purposes of computing receipts or the receipts factor under this article the following apply:
>
> (1) "Receipts" means gross income (as defined in IC § 6-5.5-1-10), plus the gross income excluded under Section 103 of the Internal Revenue Code, less gross income derived from sources outside the United States. However, upon the disposition of assets such as securities and money market transactions, when derived from transactions and activities in the regular course of the taxpayer's trade or business, receipts are limited to the gain (as defined in Section 1001 of the Internal Revenue Code) that is recognized upon the disposition.

Thus, the receipts included in the numerator of the apportionment factor are limited to those enumerated in IC § 6-5.5-4-3 through IC § 6-5.5-4-13. Moreover, the receipts included in the denominator of the apportionment factor include any gross income reported for Federal income tax purposes under Section 61 of the Internal Revenue Code. Therefore, since both Corporation A and Corporation B derived income by holding an interest in Partnership, any income received from Partnership by the corporations is taxable to the extent the income satisfies the definition of "Receipts" under IC § 6-5.5-4-2.

C. Determination of Whether Corporation B is a Subsidiary of a Financial Institution

The taxpayer claims Corporation B is not a holding company, a regulated financial corporation, a subsidiary of either, or a corporation which conducts the business of a financial institution under IC § 6-5.5-1-17(d)(2). Thus, Corporation B is not a member of the taxpayer's unitary group. The taxpayer explains Corporation A owns all the voting stock of Corporation B. The taxpayer further explains that Corporation A is not a holding company or a regulated financial corporation. Thus, Corporation B does not satisfy IC § 6-5.5-1-18; and accordingly, Corporation B is not a member of the taxpayer's unitary group for inclusion on the combined return.

As mentioned previously, a discrepancy exists between the organizational structure the taxpayer proffers in its protest brief and the structure the taxpayer provides on its Form 10-K. For the periods at issue, taxpayer's Form 10-K specifically states the following,

> ***Bank also has two investment subsidiaries, [Corporation A] and [Corporation B], which were established to hold and manage certain securities as part of a strategy to manage taxable income and reduce taxable expense. [Corporation A] and [Corporation B] subsequently entered into a limited partnership agreement, [Partnership].*** (emphasis added)

From this evidence, the Department takes the viewpoint that since the taxpayer considers Corporation B a subsidiary of Bank on its Form 10-K, then the corporation is a subsidiary of a financial institution. Moreover, after inquiring with the Secretary of State office where Corporation B is commercially domiciled and incorporated, the office indicates Corporation B established unity with Bank through common directors and officers. Hence, in the absence of definitive evidence to rebut or clarify the discrepancy, the audit was correct to take the stance Corporation B was a subsidiary of a regulated financial institution and satisfied IC § 6-5.5-5-1(a).

D. Application of the Commerce Clause to the Taxation of Corporation A and Corporation B Income on the Combined Return

The taxpayer claims even if the audit review properly included Corporation A and Corporation B on the taxpayer's combined return and could attribute Partnership's income to the corporations in their capacity as partners, the income is still beyond Indiana's jurisdiction to tax under the Commerce Clause. In *Allied Signal, Inc. v. Director, Division of Taxation,* 504 U.S. 768 (1992) the court set forth,

> The principle that a State may not tax value earned outside its borders rests on the fundamental requirement of both the Due Process and Commerce Clauses that there be 'some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.

Therefore, a state cannot tax the income unless the asset generating the income serves an "operational' rather than an "investment" function. *Allied Signal, Inc.*, 504 U.S. at 787. Accordingly, the taxpayer asserts since Corporation A and Corporation B held an interest in Partnership for long-term investment purposes and not for short-term investments of working capital, any income attributed to the corporations served an investment function rather than an operational function and was beyond Indiana's jurisdiction to tax under *Allied Signal*.

Even though, the Commerce Clause operates to limit state power in some measure, the Commerce Clause does not forestall all state taxation affecting interstate commerce. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977), *reh'g denied*, 430 U.S. 976 (1977). Nevertheless, the Indiana Supreme Court has held a constitutional analysis is beyond the Department's purview. *State v. Sproles*, 672 N.E.2d 1353, 1360 (Ind. 1996). As such, an administrative hearing with the Indiana Department of Revenue is not the proper forum to raise a Commerce Clause challenge of the application of the financial institutions tax.

E. Conclusion

The taxpayer has failed to provide definitive evidence the audit review incorrectly adjusted its combined return for tax years 2000 and 2001.

FINDING

The Department denies the Taxpayer's protest.

II. **Tax Administration** – Penalty

DISCUSSION

The taxpayer claims that it is not liable for any penalties because it had reasonable cause for its position. To support its argument, the taxpayer states the basis of its positions were as follows: upon bona fide interpretations of Indiana taxing statutes, Indiana case law, and Department policy; not due to willful neglect or intentional disregard of the law; and in good faith and with a reasonable basis. Thus, under these circumstances, the Department cannot impose a negligence penalty. *Indiana Dept. of State Revenue v. Harrison Steel Castings Co.*, 402 N.E.2d 1276, 1278 (Ind. Ct. App. 1980).

IC § 6-8.1-10-2.1(a)(3) provides in part that "if a person . . . incurs, upon examination by the department, a deficiency that is due to negligence . . . the person is subject to a penalty." Negligence is defined "as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer . . . ." 45 IAC § 15-11-2(b). Negligence is

"determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

The Department may waive the penalty upon a showing that the failure to pay the deficiency was due to reasonable cause and not due to willful neglect. IC § 6-8.1-10-2.1(d). However, in order to establish reasonable cause, the taxpayer must demonstrate that the taxpayer "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ." 45 IAC § 15-11-2(c).
The Department is unable to agree that the taxpayer's assertions rise to a level of "reasonable cause" sufficient to permit the waiver of the negligence penalty assessed against an otherwise sophisticated taxpayer.

FINDING

The Department denies the Taxpayer's protest

TG/BK/DK November 29, 2006